

KMC TELECOM HOLDINGS, INC.  
 CONSOLIDATED STATEMENTS OF NONREDEEMABLE EQUITY  
 YEARS ENDED DECEMBER 31, 1998, 1999 AND 2000  
 (IN THOUSANDS)

NONREDEEMABLE EQUITY			
	COMMON STOCK		Additional
	Shares	Amount	Paid-In Capital
BALANCE, DECEMBER 31, 1997	614	\$ 6	\$ 15,374
Conversion of Series D Preferred Stock to Series C Preferred Stock.....			
Issuance of Common stock.....			
Accretion of redeemable equity.....			(17,861)
Payment of dividends on preferred stock of subsidiary...			(592)
Issuance of warrants.....			10,446
Cancellation of KMC Telecom stock options.....			(26,191)
Issuance and adjustments to fair value of stock options to employees.....			27,906
Issuance and adjustments to fair value of stock options to non-employees.....			4,668
Amortizations of unearned compensation.....			
Net loss.....			
BALANCE, DECEMBER 31, 1998	614	6	13,750
Issuance of Series E Preferred Stock.....			
Issuance of Series F Preferred Stock.....			
Stock Dividends of Series E Preferred Stock.....			(5,004)
Stock Dividends of Series F Preferred Stock.....			(4,177)
Issuance of Warrants.....			749
Reclassification of warrants related to "put rights"....			249
Exercise of warrants.....			1
Accretion on redeemable equity.....			(76,274)
Issuance and adjustments to fair value of stock options to employees.....			27,286
Adjustment to fair value of stock options to non-employees.....			5,832
Amortization of unearned compensation.....			
Exercise of Stock options.....	15		333
Reclassification of additional paid-in capital deficiency.....			37,255
Net loss.....			
BALANCE, DECEMBER 31, 1999	629	6	--
Issuance of Series G1 Preferred Stock.....			
Issuance of Series G2 Preferred Stock.....			
Stock Dividends of Series E Preferred Stock.....			(9,951)
Stock Dividends of Series F Preferred Stock.....			(6,654)
Accretion on redeemable equity.....			(93,535)
Issuance and adjustments to fair value of stock options to employees.....			38,218
Issuance and adjustments to fair value of stock options to non-employees.....			3,796
Exercise of Stock options.....	8		562
Amortization of unearned compensation.....			
Redemption and retirement of Series F Preferred Stock...			
Reclassification of additional paid-in capital deficiency.....			67,564
Net loss.....			
BALANCE, DECEMBER 31, 2000	637	\$ 6	\$ --

SEE ACCOMPANYING NOTES.

KMC TELECOM HOLDINGS, INC.  
 CONSOLIDATED STATEMENTS OF REDEEMABLE EQUITY  
 YEARS ENDED DECEMBER 31, 1998, 1999 AND 2000  
 (IN THOUSANDS)

NONREDEEMABLE EQUITY

Total

	Unearned Compensation	Accumulated Deficit	Nonredeemable Equity (Deficiency)
BALANCE, DECEMBER 31, 1997	\$ (6,521)	\$ (35,532)	\$ (26,673)
Conversion of Series D Preferred Stock to Series C Preferred Stock.....			
Issuance of Common stock.....			(17,861)
Accretion of redeemable equity.....			(592)
Payment of dividends on preferred stock of subsidiary...			10,446
Issuance of warrants.....			(21,346)
Cancellation of KMC Telecom stock options.....	4,845		
Issuance and adjustments to fair value of stock options to employees.....	(27,906)		--
Issuance and adjustments to fair value of stock options to non-employees.....			4,668
Amortizations of unearned compensation.....	23,758		23,758
Net loss.....		(76,753)	(76,753)
BALANCE, DECEMBER 31, 1998	(5,824)	(112,285)	(104,353)
Issuance of Series E Preferred Stock.....			
Issuance of Series F Preferred Stock.....			(5,004)
Stock Dividends of Series E Preferred Stock.....			(4,177)
Stock Dividends of Series F Preferred Stock.....			749
Issuance of Warrants.....			249
Reclassification of warrants related to "put rights"....			1
Exercise of warrants.....			(76,274)
Accretion on redeemable equity.....			
Issuance and adjustments to fair value of stock options to employees.....	(27,286)		--
Adjustment to fair value of stock options to non-employees.....			5,832
Amortization of unearned compensation.....	23,947		23,947
Exercise of Stock options.....			333
Reclassification of additional paid-in capital deficiency.....		(37,255)	--
Net loss.....		(225,716)	(225,716)
BALANCE, DECEMBER 31, 1999	\$ (9,163)	\$ (375,256)	\$ (384,413)
Issuance of Series G1 Preferred Stock.....			-
Issuance of Series G2 Preferred Stock.....			-
Stock Dividends of Series E Preferred Stock.....			(9,951)
Stock Dividends of Series F Preferred Stock.....			(6,654)
Accretion on redeemable equity.....			(93,535)
Issuance and adjustments to fair value of stock options to employees.....	(38,218)		-
Issuance and adjustments to fair value of stock options to non-employees.....			3,796
Exercise of Stock options.....			562
Amortization of unearned compensation.....	30,773		30,773
Redemption and retirement of Series F Preferred Stock...		(362)	(362)
Reclassification of additional paid-in capital deficiency.....		(67,564)	-
Net loss.....		(359,687)	(359,687)
BALANCE, DECEMBER 31, 2000	\$ (16,608)	\$ (802,869)	\$ (819,471)

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KMC TELECOM HOLDINGS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)

	YEAR ENDED DECEMBER 31		
	1998	1999	2000
OPERATING ACTIVITIES			
Net loss.....	\$ (76,753)	\$ (225,716)	\$ (359,687)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization.....	9,257	29,077	76,129

Provision for doubtful accounts.....	370	5,263	7,875
Non-cash interest expense.....	25,356	31,141	45,635
Non-cash stock option compensation expense.....	7,080	29,833	34,571
Changes in assets and liabilities:			
Accounts receivable.....	(6,591)	(25,097)	(27,643)
Prepaid expenses and other current assets.....	(826)	(60)	(2,513)
Other assets.....	(1,821)	3,720	(9)
Accounts payable.....	7,449	29,319	31,541
Accrued expenses.....	1,719	21,105	34,123
Deferred revenue.....	1,187	3,122	13,530
Net cash used in operating activities.....	(33,573)	(98,293)	(146,448)
INVESTING ACTIVITIES			
Construction of networks and purchases of equipment.....	(148,580)	(318,536)	(476,640)
Acquisitions of franchises, authorizations and related assets....	(1,147)	(1,992)	(926)
Deposit on purchase of equipment.....	(2,551)	-	-
Additions to restricted investments.....	-	-	(43,471)
Purchase of investments, net.....	(27,920)	-	-
Redemption of investments.....	-	43,450	32,085
Net cash used in investing activities.....	(180,198)	(277,078)	(488,952)
FINANCING ACTIVITIES			
Proceeds from notes payable, net of issuance costs.....	938	-	108,475
Proceeds from issuance of common stock and warrants, net of issuance costs.....	20,446	-	-
Proceeds from issuance of preferred stock and related warrants, net of issuance costs.....	-	91,001	177,500
Issuance costs of credit facilities.....	(6,515)	(2,300)	-
Proceeds from exercise of stock options.....	-	333	562
Proceeds from issuance of senior notes, net of issuance costs and purchase of portfolio of restricted investments.....	-	158,286	-
Proceeds from senior secured credit facility, net of issuance costs.....	-	192,836	376,203
Repayment of notes payable.....	(20,801)	-	-
Repurchase and retirement of Series F Preferred Stock.....	-	-	(3,329)
Proceeds from issuance of senior discount notes, net of issuance costs.....	225,923	-	-
Dividends on preferred stock of subsidiary.....	(592)	-	-
Net cash provided by financing activities.....	219,399	440,156	659,411
Net increase in cash and cash equivalents.....	5,628	64,785	24,011
Cash and cash equivalents, beginning of year.....	15,553	21,181	85,966
Cash and cash equivalents, end of year.....	\$ 21,181	\$ 85,966	\$ 109,977
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Cash paid during the year for interest, net of amounts capitalized.....	\$ 4,438	\$ 29,182	\$ 80,374

SEE ACCOMPANYING NOTES.

KMC TELECOM HOLDINGS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2000

1. ORGANIZATION

KMC Telecom Holdings, Inc. ("KMC Holdings") is a holding company formed during 1997 primarily to own all of the shares of its then operating subsidiaries, KMC Telecom Inc. ("KMC Telecom"), KMC Telecom II, Inc. ("KMC Telecom II"), KMC Telecom III, Inc. ("KMC Telecom III") and KMC Telecom of Virginia, Inc. KMC Telecom Holdings, Inc. and its subsidiaries are collectively referred to herein as the Company. All significant intercompany transactions and balances have been eliminated in consolidation.

The Company is a fiber-based integrated communications provider offering data, voice and Internet infrastructure services. The Company offers these services to businesses, governments and institutional end-users, Internet service providers, long distance carriers and wireless service providers, primarily in the South, Southeast, Midwest and Mid-Atlantic United States. The business has two distinct components: serving communications-intensive customers in Tier III markets, and providing data services on a nationwide basis.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### BASIS OF PRESENTATION

On July 1, 1999, the Company acquired all of the membership interests of KMC Services LLC from Harold N. Kamine, the Chairman of the Board of Directors, for nominal consideration. KMC Services LLC was formed to provide services to the Company and its customers, initially offering a leasing program for equipment physically installed at the customer's premises. The acquisition was accounted for as a combination of entities under common control, and no changes were made to the historical cost basis of KMC Services LLC's assets. During the second quarter of 1999, the Company had reduced the carrying value of its \$709,000 loan receivable from KMC Services LLC to an amount equal to the value of KMC Services LLC's net assets at the acquisition date. KMC Services LLC has been consolidated with the Company since July 1, 1999.

The Company has incurred significant operating and net losses as a result of the development and operation of its networks, and expects that such losses will continue as it emphasizes the development, construction and expansion of its networks and building its customer base. As a result, the Company does not expect there to be any cash provided by operations in the near future. The Company will also need to fund the expansion of its networks as well as to fund capital expenditures related to its nationwide data platform business. To date, the Company has financed its operating losses and capital expenditures with equity invested by its founders, preferred stock placements, credit facility borrowings, equipment loans, operating leases, monetizations and its 12 1/2% senior discount notes and 13 1/2% senior notes. Actual capital expenditures and operating losses will depend on numerous factors, including the nature of future expansion and acquisition opportunities and factors beyond the Company's control, including economic conditions, competition, regulatory developments and the availability of capital.

As more fully described in Note 18, the Company entered into two financing transactions in March 2001 which generated aggregate unrestricted net proceeds of approximately \$271.0 million and, in April 2001, further amended its Amended Senior Secured Credit Facility to, among other things, revise certain of the financial covenants to be less restrictive.

After giving effect to these transactions, management believes that the Company's cash and borrowings available under the Amended Senior Secured Credit Facility will be sufficient to meet its liquidity needs on a going concern basis to fund operating losses and capital expenditure requirements for all of its Tier III markets, its current Nationwide Data Platform contracts and other existing commitments into the second quarter of 2002. However, in the event that such plans change, the assumptions upon which such plans are based prove inaccurate, the Company expands or accelerates its business plan or determines to consummate acquisitions, the foregoing sources of funds may prove insufficient and the Company may be required to seek additional financing sooner than currently expected. Additional sources of financing may include public or private equity or debt financings, leases and other financing arrangements.

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### CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

### NETWORKS, PROPERTY AND EQUIPMENT

Networks, property and equipment are stated at cost, net of accumulated depreciation. Depreciation is provided over the estimated useful lives of the respective assets using the straight-line method for financial statement reporting purposes.

The estimated useful lives of the Company's principal classes of assets are as follows:

Networks:

Fiber optic systems.....	20 years
Telecommunications equipment.....	10 years
Furniture and other.....	5 years
Leasehold improvements.....	Life of lease

INTANGIBLE ASSETS

Costs incurred in developing new networks or expanding existing networks, including negotiation of rights-of-way and obtaining regulatory authorizations are capitalized and amortized over the initial term of the agreements, which generally range from 2 to 7 years. Costs incurred to obtain city franchises are capitalized by the Company and amortized over the initial term of the franchises, which generally range from 2 to 7 years.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company records impairment losses on long-lived assets used in operations or expected to be disposed of when impairment indicators are present and the cash flows expected to be derived from those assets are less than the carrying amounts of those assets. An impairment loss is measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset. There were no material impairments of assets during the year.

DEFERRED FINANCING COSTS

The Company capitalizes issuance costs related to its debt. Such costs are amortized utilizing the interest method over the lives of the related debt. The related amortization is included as a component of interest expense, and amounted to \$2,279,000, \$3,814,000 and \$7,721,000 for the years ended December 31, 1998, 1999 and 2000, respectively.

OTHER ASSETS

Other assets are comprised principally of employee loans, security deposits and other deposits.

REVENUE RECOGNITION

Revenue is recognized in the period the service is provided, except for installation revenue which is recorded over the average contract period (see "ACCOUNTING CHANGE" below). The Company generally invoices customers one month in advance for recurring services resulting in deferred revenue. However, some services, such as reciprocal compensation, are not billed in advance resulting in unbilled revenue included in accounts receivable. The accounts receivable balances for services which will be billed in the succeeding month totaled \$5,305,000 and \$4,119,000 at December 31, 1999 and 2000, respectively.

ACCOUNTING CHANGE

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), REVENUE RECOGNITION IN FINANCIAL STATEMENTS. SAB 101 provides additional guidance in applying generally accepted accounting principles to revenue recognition in financial statements. Through December 31, 1999, the Company recognized installation revenue upon completion of the installation. Effective January 1, 2000, in accordance with the provisions of SAB 101, the Company is recognizing installation revenue over the average contract period. The cumulative effect of this change in accounting principle resulted in a charge of approximately \$1.7 million which was recorded in the quarter ended March 31, 2000. For the year ended December 31, 2000, the net effect of adopting this change in accounting principle was a deferral of the

recognition of \$3.0 million of revenue, which increased net loss for the period by \$3.56 per share. Revenue for the year ended December 31, 2000 includes \$1.7 million of revenues that, prior to the accounting change, had been recognized through December 31, 1999.

#### NET LOSS PER COMMON SHARE

Earnings per share are calculated in accordance with FASB Statement No. 128, EARNINGS PER SHARE ("Statement 128"). All earnings per share amounts for all periods have been presented in accordance with the provisions of Statement 128. Diluted earnings per share have not been presented for any period, as the impact of including outstanding options and warrants would be anti-dilutive.

#### INCOME TAXES

The Company accounts for income taxes in accordance with FASB Statement No. 109, "ACCOUNTING FOR INCOME TAXES," which requires that deferred income taxes be recorded based on differences between the financial reporting and tax reporting bases of assets and liabilities, using enacted tax rates.

#### ADVERTISING COSTS

Advertising costs are included in selling, general and administrative expenses and charged to expense as incurred. For the years ended December 31, 1998, 1999 and 2000, such costs were \$2,769,000, \$4,080,000 and \$6,851,000, respectively.

#### USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

#### STOCK-BASED COMPENSATION

As permitted by FASB Statement No. 123, ACCOUNTING FOR STOCK-BASED COMPENSATION ("Statement 123"), the Company has elected to follow Accounting Principles Board Opinion No. 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES ("APB 25") and related interpretations in accounting for its employee stock-based compensation. Under APB 25, no compensation expense is recognized at the time of option grant if the exercise price of the employee stock option is fixed and equals or exceeds the fair market value of the underlying common stock on the date of grant, and the number of shares to be issued pursuant to the exercise of such option are known and fixed at the grant date. As more fully described in Note 7, the Company's outstanding stock options are not considered fixed options under APB 25. The Company accounts for non-employee stock-based compensation in accordance with Statement 123.

#### SEGMENT REPORTING

In 1998, the Company adopted FASB Statement No. 131, DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION ("Statement 131"). Statement 131 uses a management approach to report financial and descriptive information about an entity's operating segments. Operating segments are revenue-producing components of an enterprise for which separate financial information is produced internally for the entity's chief operating decision maker. Under this

definition, the Company operated within a single segment until the commencement of our Nationwide Data Platform Business in 2000. See Note 8 for the Company's detailed segment disclosure.

#### RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 1998, the Financial Accounting Standards Board issued Statement No. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

("Statement 133"), which will require the Company to recognize all derivatives on the balance sheet at fair value. The Company will be required to adopt Statement 133, as amended by Statement No. 137 which defers the effective date, as of January 1, 2001. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. The Company has two interest rate swap agreements to hedge its interest rate exposure (see Note 6), and the estimated effect of applying Statement 133 as of December 31, 2000 would have resulted in the fair value of the swaps of \$13.2 million being included as an asset with a corresponding credit to other comprehensive income.

#### RECLASSIFICATIONS

Certain reclassifications have been made to the 1998 and 1999 consolidated financial statements to conform with the 2000 presentation.

#### 3. NETWORKS, PROPERTY AND EQUIPMENT

Networks and equipment are comprised of the following:

	DECEMBER 31,	
	1999	2000
	(IN THOUSANDS)	
Fiber optic systems.....	\$ 150,647	\$ 249,690
Telecommunications equipment.....	436,056	696,683
Furniture and other.....	21,397	27,790
Leasehold improvements.....	1,811	2,704
Construction-in-progress.....	66,380	157,075
	676,291	1,133,942
Less accumulated depreciation.....	(36,967)	(112,258)
	\$ 639,324	\$ 1,021,684
	=====	=====

Costs capitalized during the development of the Company's networks include amounts incurred related to network engineering, design and construction and capitalized interest. Capitalized interest related to the construction of the networks during the years ended December 31, 1998, 1999 and 2000 amounted to \$5,133,000, \$6,635,000, and \$10,384,000 respectively.

For the years ended December 31, 1998, 1999 and 2000, depreciation expense was \$8,284,000, \$27,723,000, and \$75,434,000 respectively.

#### 4. ACCRUED EXPENSES

Accrued expenses are comprised of the following:

DECEMBER 31,

	1999	2000
	(IN THOUSANDS)	
Accrued compensation.....	\$ 11,423	\$ 20,068
Accrued interest payable.....	8,544	20,419
Accrued telecommunications costs.....	3,794	8,125
Accrued costs related to financing activities.....	7,316	1,593
Other accrued expenses.....	5,970	23,400
	<u>\$ 37,047</u>	<u>\$ 73,605</u>

## 5. LONG-TERM DEBT

### KMC FUNDING INTERNET INFRASTRUCTURE EQUIPMENT FINANCING

In November 2000, our subsidiary, KMC Telecom Funding Corporation, entered into an agreement with Dresdner Kleinwort Benson North American Leasing, Inc. to finance the \$168 million of Internet infrastructure equipment purchased from Qwest Communications Corporation in June 2000 (the "KMC Funding Equipment") (See Note 9). The maximum aggregate loan amount is \$168 million and the proceeds from this loan can be drawn down in installments through April 30, 2001 to fund the vendor payments due on the KMC Funding Equipment. Borrowings under this loan bear interest payable at a rate of 200 basis points above the LIBOR Rate through October 15, 2001 and 600 basis points over the LIBOR Rate thereafter. The loan is secured by the KMC Funding Equipment and requires 48 monthly payments commencing on December 15, 2000. The first 6 payments are interest only, and the remaining payments include principal and interest. The loan was amended in March 2001 to allow the Company to borrow an additional \$21 million. As of December 31, 2000, the outstanding balance on this loan was \$110 million and an additional \$79 million was drawn down through March 2001. As more fully described in Note 18, the loan was repaid in full in March 2001, using a portion of the proceeds from the KMC Funding Monetization.

### AMENDED SENIOR SECURED CREDIT FACILITY

During the quarter ended March 31, 2000, the Company's subsidiaries, KMC Telecom, Inc., KMC Telecom II, Inc., KMC Telecom of Virginia, Inc. and KMC Telecom III, Inc. (collectively, the "Borrowers"), amended, restated and combined the Senior Secured Credit Facility and the Lucent Loan and Security Agreement, into a single facility by entering into a \$700 million Loan and Security Agreement (the "Amended Senior Secured Credit Facility") with a group of lenders led by CIT Lending Services Corporation (formerly Newcourt Commercial Finance Corporation), GE Capital Corporation, Canadian Imperial Bank of Commerce, First Union National Bank and Lucent Technologies Inc. (collectively, the "Lenders").

The Amended Senior Secured Credit Facility includes a \$175 million reducing revolver facility (the "Revolver"), a \$75 million term loan (the "Term Loan") and a \$450 million term loan facility (the "Lucent Term Loan"). At December 31, 2000, the outstanding loan balances on the Revolver, the Term Loan and the Lucent Term Loan, were approximately \$165 million, \$75 million, and \$378 million, respectively. Up to \$10 million of the Revolver can be used for letters of credit and as of December 31, 2000, approximately \$7 million had been drawn against the Revolver for letters of credit.

The Revolver will mature on April 1, 2007. Proceeds from the Revolver can be used to finance the purchase of certain equipment, transaction costs and, upon attainment of certain financial conditions, for working capital and other general corporate purposes. The aggregate commitment of the Lenders under the Revolver will be reduced on each quarterly payment date beginning April 1, 2003. The initial quarterly commitment reduction is 5.0%, reducing to 3.75% on July 1, 2003, then increasing to 6.25% on July 1, 2004, and further increasing to 7.50% on July 1, 2006. Commencing with the fiscal year ending December 31, 2001, the aggregate Revolver commitment will be further reduced by an amount equal to 50% of excess operating cash flows (as defined in the Amended Senior Secured Credit



Facility) for the prior fiscal year until the Borrowers achieve certain financial conditions. The Borrowers must pay an annual commitment fee on the unused portion of the Revolver ranging from .75% to 1.25%.

The Term Loan is payable in twenty consecutive quarterly installments of \$188,000 beginning on April 1, 2002 and two final installments of \$35.6 million each on April 1, 2007 and July 1, 2007. Proceeds from the Term Loan can be used to finance the purchase of certain equipment, transaction costs, working capital and other general corporate purposes.

The Lucent Term Loan provides for an aggregate commitment of up to \$450 million. Proceeds from the Lucent Term Loan can be used to purchase Lucent products or to reimburse the Borrowers for Lucent products previously purchased with cash or other sources of liquidity. The Lucent Term Loan will mature on July 1, 2007 and requires quarterly principal payments beginning on July 1, 2003 of 5%. The principal payment decreases to 3.75% per quarter beginning on October 1, 2003, increases to 6.25% on October 1, 2004 and further increases to 7.50% on October 1, 2006. An annual commitment fee of 1.50% is payable for any unused portion of the Lucent Term Loan.

Borrowings under the Amended Senior Secured Credit Facility bear interest payable, at the Borrowers' option, at either (a) the "Applicable Base Rate Margin" (which generally ranges from 2.00% to 3.25%) plus the greater of (i) the administrative agent's prime rate or (ii) the overnight federal funds rate plus .5% or (b) the "Applicable LIBOR Margin" (which generally ranges from 3.00% to 4.25%) plus LIBOR, as defined. "Applicable Base Rate Margin" interest is payable quarterly while "Applicable LIBOR Margin" interest is payable at the end of each applicable interest period or at least every three months. Under the Amended Senior Secured Credit Facility the Borrowers were being charged a weighted average interest rate of 11.87% at December 31, 2000 (10.26% at December 31, 1999 and 9.38% at December 31, 1998). If a payment default were to occur, the interest rate will be increased by four percentage points. If any other event of default were to occur, the interest rate will be increased by two percentage points.

KMC Holdings has unconditionally guaranteed the repayment of the Amended Senior Secured Credit Facility when such repayment is due, whether at maturity, upon acceleration, or otherwise. KMC Holdings has pledged the shares of each of the Borrowers to the Lenders to collateralize its obligations under the guaranty. In addition, the Borrowers have each pledged all of their assets to the Lenders.

The Amended Senior Secured Credit Facility contains a number of affirmative and negative covenants, one of which requires us to make additional cash capital contributions to our subsidiaries which are the borrowers thereunder of at least \$35 million prior to August 31, 2001. The original covenant required \$185 million in cash capital contributions by April 1, 2001. However, because we contributed \$150 million of the proceeds of our Series G private equity financing toward fulfilling this requirement, the Lenders amended this covenant by extending the due date on the remaining \$35 million of cash capital contributions to August 31, 2001. Because the entire \$185 million cash capital contribution was not made by July 31, 2000, however, the applicable interest rate associated with the facility was increased by 100 basis points. Additional affirmative and negative covenants include, among others, covenants restricting the ability of the Borrowers to consolidate or merge with any person, sell or lease assets not in the ordinary course of business, sell or enter into long term leases of dark fiber, redeem stock, pay dividends or make any other payments (including payments of principal or interest on loans) to KMC Holdings, create subsidiaries, transfer any permits or licenses, or incur additional indebtedness or act as guarantor for the debt of any person, subject to certain conditions.

The Borrowers are required to comply with certain financial tests and maintain certain financial ratios, including, among others, a ratio of total debt to contributed capital, certain minimum revenues, maximum EBITDA losses and minimum EBITDA, maximum capital expenditures and minimum access lines, a maximum total leverage ratio, a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a maximum consolidated leverage ratio.

Failure to satisfy any of the financial covenants will constitute an event of default under the Amended Senior Secured Credit Facility permitting the Lenders, after notice, to terminate the commitment and/or accelerate payment of outstanding indebtedness thereunder. The Amended Senior Secured Credit Facility also includes other customary events of default, including, without limitation, a cross-default to other material indebtedness, material undischarged judgments, bankruptcy, loss of a material franchise or material license, breach of representations and warranties, a material adverse change, and the occurrence of a change of control.

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As of December 31, 2000, the borrowers were in compliance with all of the financial covenants of the facility.

In April 2001, the Company further amended the Amended Senior Secured Credit Facility. This amendment made a number of significant changes in the facility, although it did not change the overall amount of the facility or the purposes for which proceeds of loans under the facility may be used. In connection with the amendment, the Lenders also waived failures by the Borrowers to comply with certain of the prior financial covenants as of March 31, 2001 and the Company made aggregate capital contributions to the Borrowers of \$200.0 million (which satisfied the \$35 million requirement discussed above). In addition, the collateral for KMC Holdings' guaranty of the facility was expanded to include substantially all of the assets of KMC Holdings. See Note 18 for a detailed description of this amendment.

#### TELECOM IV SENIOR SECURED TERM LOAN

During the quarter ended June 30, 2000, the Company's subsidiary, KMC Telecom, IV, Inc., closed a new senior secured term loan (the "Telecom IV Loan") with Lucent Technologies Inc. The Telecom IV Loan initially provided up to \$35 million of principal borrowings, plus accrued interest, until certain conditions were met and then provided for additional principal borrowings up to a ceiling of \$50 million, plus accrued interest. In December 2000, the Company and Lucent agreed to terminate this arrangement and the equipment purchased with funds from the Telecom IV Loan was returned to Lucent. Accordingly, the Telecom IV Loan balance was extinguished in full and this facility is no longer available to the Company.

#### SENIOR DISCOUNT NOTES

On January 29, 1998, KMC Holdings sold 460,800 units, each unit consisting of a 12 1/2% senior discount note with a principal amount at maturity of \$1,000 due 2008 pursuant to the Senior Discount Note Indenture between KMC Holdings and the Chase Manhattan Bank, as trustee (the "Senior Discount Notes") and one warrant to purchase .21785 shares of Common Stock of KMC Holdings at an exercise price of \$.01 per share. The gross and net proceeds of the offering were approximately \$250 million and \$236.4 million, respectively. A substantial portion of the net proceeds of the offering have been loaned by KMC Holdings to its subsidiaries. On August 11, 1998, KMC Holdings exchanged the notes issued on January 29, 1998 for \$460.8 million aggregate principal amount at maturity of notes that had been registered under the Securities Act of 1933 (as used below and elsewhere herein, "Senior Discount Notes" includes the original notes and the exchange notes).

The Senior Discount Notes are unsecured, unsubordinated obligations of the Company and mature on February 15, 2008. The Senior Discount Notes were sold at a substantial discount from their principal amount at maturity, and there will not be any payment of interest on the Senior Discount Notes prior to August 15, 2003. The Senior Discount Notes will fully accrete to face value on February 15, 2003. From and after February 15, 2003, the Senior Discount Notes will bear interest, which will be payable in cash, at the rate of 12.5% per annum on February 15 and August 15 of each year, commencing August 15, 2003. The Company is accreting the initial carrying value of the Senior Discount Notes to their aggregate face value over the term of the debt at its effective interest rate of 13.7%.

The Senior Discount Notes are redeemable, at the Company's option, in whole or in part, on or after February 15, 2003 and prior to maturity, at redemption prices equal to 106.25% of the aggregate principal amount at maturity, plus accrued and unpaid interest, if any, to the redemption date, declining to 100% of the aggregate principal amount at maturity, plus accrued and unpaid interest as of February 15, 2006.

The indebtedness evidenced by the Senior Discount Notes ranks *pari passu* in right of payment with all existing and future unsubordinated, unsecured indebtedness of KMC Holdings and senior in right of payment to all existing and future subordinated indebtedness of KMC Holdings. However, KMC Holdings is a holding company and the Senior Discount Notes are, therefore, effectively subordinated to all existing and future liabilities (including trade payables) of its subsidiaries.

Within 30 days of the occurrence of a Change of Control (as defined in the Senior Discount Note Indenture), the Company must offer to purchase for cash all Senior Discount Notes then outstanding at a purchase price equal to 101% of the accreted value thereof, plus accrued interest. The Company's ability to comply with this requirement is subject to certain restrictions contained in the Amended Senior Secured Credit Facility.

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The Senior Discount Note Indenture contains events of default, including, but not limited to, (i) defaults in the payment of principal, premium or interest, (ii) defaults in compliance with covenants contained in the Senior Discount Note Indenture, (iii) cross defaults on more than \$5 million of other indebtedness, (iv) failure to pay more than \$5 million of judgments that have not been stayed by appeal or otherwise and (v) the bankruptcy of KMC Holdings or certain of its subsidiaries.

The Senior Discount Note Indenture restricts, among other things, the ability of KMC Holdings to incur additional indebtedness, create liens, engage in sale-leaseback transactions, pay dividends or make distributions in respect of capital stock, make investments or certain other restricted payments, sell assets of KMC Holdings, redeem capital stock, issue or sell stock of restricted subsidiaries, enter into transactions with stockholders or affiliates or effect a consolidation or merger. The Senior Discount Note Indenture permits KMC Holdings' subsidiaries to be deemed unrestricted subsidiaries and, thus, not subject to the restrictions of the Senior Discount Note Indenture.

The Senior Discount Notes are "applicable high yield discount obligations" ("AHYDOs"), as defined in the Internal Revenue Code of 1986, as amended. Under the rules applicable to AHYDOs, a portion of the original issue discount ("OID") that accrues on the Senior Discount Notes will not be deductible by the Company at any time. Any remaining OID on the Senior Discount Notes will not be deductible by the Company until such OID is paid.

#### SENIOR NOTES

On May 24, 1999, KMC Holdings issued \$275.0 million aggregate principal amount of 13 1/2% Senior Notes due 2009. On December 30, 1999, KMC Holdings exchanged the notes issued on May 24, 1999 for \$275.0 million aggregate principal amount of notes that had been registered under the Securities Act of 1933 (as used below and elsewhere herein, "Senior Notes" includes the original notes and the exchange notes). Interest on the Senior Notes is payable semi-annually in cash on May 15 and November 15 of each year, beginning November 15, 1999. A portion of the proceeds from the offering of the Senior Notes was used to purchase a portfolio of U.S. government securities that were pledged as security for the first six interest payments on the Senior Notes.

The Senior Notes are redeemable, at the Company's option, in whole or in part, on or after May 15, 2004 and prior to maturity, at redemption prices equal to 106.75% of the aggregate principal amount at maturity, plus accrued and unpaid interest, if any, to the redemption date, declining to 100% of the aggregate principal amount at maturity, plus accrued and unpaid interest as of

May 15, 2007.

In addition, at any time prior to May 15, 2002, the Company may redeem up to 35% of the aggregate principal amount at maturity of the Senior Notes with the net proceeds from the sale of common equity at a redemption price of 113.5% of the principal amount on such date plus accrued and unpaid interest. Upon a change of control (as defined in the Senior Note Indenture), the Company must offer to purchase for cash the Senior Notes at a purchase price equal to 101% of the principal amount, plus accrued interest. The Company's ability to comply with this requirement is subject to certain restrictions contained in the Amended Senior Secured Credit Facility.

The Senior Notes are guaranteed by KMC Telecom Financing, Inc., a wholly-owned subsidiary. The Senior Notes are senior, unsecured, unsubordinated obligations of KMC Holdings and rank pari passu in right of payment with all existing and future unsubordinated, unsecured indebtedness of KMC Holdings and senior in right of payment to all of existing and future subordinated indebtedness of KMC Holdings. However, KMC Holdings is a holding company and the Senior Notes are, therefore, effectively subordinated to all existing and future liabilities (including trade payables), of its subsidiaries.

The Senior Note Indenture contains certain covenants that, among other things, limit the Company's ability to incur additional indebtedness, engage in sale-leaseback transactions, pay dividends or make certain other distributions, sell assets, redeem capital stock, effect a consolidation or merger of KMC Telecom Holdings, Inc. and enter into transactions with stockholders and affiliates and create liens on our assets.

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#### 6. INTEREST RATE SWAP AGREEMENTS

##### AMENDED AND RESTATED INTEREST RATE SWAP AGREEMENT

In April 2000, the Company entered into an amended and restated interest rate swap agreement (the "Amended Swap") with a commercial bank to reduce the impact of changes in interest rates on a portion of its outstanding variable rate debt. The Amended Swap effectively fixes the Company's interest rate on \$325 million of outstanding variable rate borrowings under the Amended Senior Secured Credit Facility (see Note 5) through April 2003, after which time the Amended Swap is reduced to \$225 million through January 2004 and then finally reduced to \$100 million until termination of the Amended Swap in April 2005. The Company is exposed to credit loss in the event of nonperformance by the other party to the interest rate swap agreement. However, the Company does not anticipate nonperformance by the counterparty.

##### JUNE 2000 SWAP AGREEMENT

In June 2000, the Company entered into a second interest rate swap agreement (the "June 2000 Swap") with a commercial bank to reduce the impact of changes in interest rates on an additional portion of its outstanding variable rate debt. The June 2000 Swap effectively fixes the Company's interest rate on an additional \$90 million of its outstanding variable rate borrowings under the Amended Senior Secured Credit Facility for a period of five years. The Company is exposed to credit loss in the event of nonperformance by the other party to the interest rate swap agreement. However, the Company does not anticipate nonperformance by the counterparty.

#### 7. REDEEMABLE AND NONREDEEMABLE EQUITY

##### SERIES G PREFERRED STOCK

In July 2000, the Company issued 58,881 and 481,108 shares of Series G-1 Voting and G-2 Non-Voting Convertible Preferred Stock (the "Series G Preferred Stock"), respectively, to Lucent Technologies, Dresdner Kleinwort Benson Private Equity Partners, CIT Lending Services, Nassau Capital Partners and Harold N. Kamine, its Chairman of the Board, for aggregate gross proceeds of \$182.5 million. The Series G Preferred Stock has a liquidation preference of

\$337.97 per share and an annual cumulative dividend equal to 7.0% of the liquidation preference. Payment of the unpaid dividends is triggered by (i) an initial public offering in which the Company receives aggregate gross proceeds of at least \$80 million or (ii) a merger, consolidation or sale of substantially all assets. As of December 31, 2000, accumulated but unpaid dividends on the Series G Preferred Stock aggregated \$6,388,000.

Each share of Series G Preferred Stock is convertible into a number of shares of Common Stock equal to the liquidation preference of each share divided by the conversion price then in effect. Initially, the conversion price is \$337.97. However, this price is adjustable, subject to certain exceptions, upon the occurrence of certain events including (i) the issuance or sale of common stock for a consideration per share less than the conversion price, (ii) the issuance of rights or options to acquire common stock or convertible securities with an exercise price less than the conversion price and (iii) the issuance or sale of other convertible securities with a conversion or exchange price lower than the conversion price. The Series G Preferred Stock will be automatically converted into common stock upon (i) a Qualified Public Offering, defined as sale of common stock pursuant to a registration statement in which the Company receives aggregate gross proceeds of at least \$80 million, provided that the per share price at which such shares are sold in such offering is not less than the liquidation preference then in effect, or (ii) the election of holders of at least two-thirds of the outstanding shares of Series G Preferred Stock.

The Series G Preferred Stock ranks senior to the Common Stock, Series A Convertible Preferred Stock and Series C Convertible Preferred Stock, on a parity with the Series F Senior Redeemable, Exchangeable, PIK Preferred Stock and junior to the Series E Senior Redeemable, Exchangeable, PIK Preferred Stock. The Series G-1 shareholders are entitled to vote on all matters before the common holders, as a single class with the common, on an as if converted basis.

Subject to certain limitations and conditions, at the request of the holders of at least two-thirds of the Series G Preferred Stock, the Company may be required to redeem the Series G Preferred Stock upon (i) a change of control or sale of the Company, or (ii) August 15, 2009.

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#### SERIES E PREFERRED STOCK

On February 4, 1999, the Company issued 25,000 shares of Series E Senior Redeemable, Exchangeable, PIK Preferred Stock (the "Series E Preferred Stock") to Newcourt Finance (now CIT Lending Services), generating aggregate gross proceeds of \$22.9 million. On April 30, 1999, the Company issued an additional 35,000 shares of Series E Preferred Stock for gross proceeds of \$25.9 million. The Series E Preferred Stock has a liquidation preference of \$1,000 per share and an annual dividend equal to 14.5% of the liquidation preference, payable quarterly. On or before January 15, 2004, the Company may pay dividends in cash or in additional fully paid and nonassessable shares of Series E Preferred Stock. After January 15, 2004, dividends must be paid in cash, subject to certain conditions. Unpaid dividends accrue at the dividend rate of the Series E Preferred Stock, compounded quarterly. During 1999 and 2000, the Company issued 5,004 and 9,951 shares of Series E Preferred Stock, respectively, to pay the dividends due for such periods.

The Series E Preferred Stock must be redeemed on February 1, 2011, subject to the legal availability of funds therefor, at a redemption price, payable in cash, equal to the liquidation preference thereof on the redemption date, plus all accumulated and unpaid dividends to the date of redemption. After April 15, 2004, the Series E Preferred Stock may be redeemed, in whole or in part, at the option of the Company, at a redemption price equal to 110% of the liquidation preference of the Series E Preferred Stock plus all accrued and unpaid dividends to the date of redemption. The redemption price declines to an amount equal to 100% of the liquidation preference as of April 15, 2007.

In addition, on or prior to April 15, 2002, the Company may, at its option, redeem up to 35% of the aggregate liquidation preference of Series E Preferred Stock with the proceeds of sales of its capital stock at a redemption

price equal to 110% of the liquidation preference on the redemption date plus accrued and unpaid dividends.

The holders of Series E Preferred Stock have voting rights in certain circumstances. Upon the occurrence of a change of control, the Company will be required to make an offer to repurchase the Series E Preferred Stock for cash at a purchase price of 101% of the liquidation preference thereof, together with all accumulated and unpaid dividends to the date of purchase.

The Series E Preferred Stock is not convertible. The Company may, at the sole option of the Board of Directors (out of funds legally available), exchange all, but not less than all, of the Series E Preferred Stock then outstanding, including any shares of Series E Preferred Stock issued as payment for dividends, for a new series of subordinated debentures (the "Exchange Debentures") issued pursuant to an exchange debenture indenture. The holders of Series E Preferred Stock are entitled to receive on the date of any such exchange, Exchange Debentures having an aggregate principal amount equal to (i) the total of the liquidation preference for each share of Series E Preferred Stock exchanged, plus (ii) an amount equal to all accrued but unpaid dividends payable on such share.

#### SERIES F PREFERRED STOCK

On February 4, 1999, the Company issued 40,000 shares of Series F Senior Redeemable, Exchangeable, PIK Preferred Stock (the "Series F Preferred Stock") to Lucent and Newcourt Finance (now CIT Lending Services Corporation), generating aggregate gross proceeds of \$38.9 million. The Series F Preferred Stock has a liquidation preference of \$1,000 per share and an annual dividend equal to 14.5% of the liquidation preference, payable quarterly. The Company may pay dividends in cash or in additional fully paid and nonassessable shares of Series F Preferred Stock. During 1999 and 2000, the Company issued 4,177 and 6,654 shares of Series F Preferred Stock, respectively, to pay the dividends due for such periods.

The Series F Preferred Stock may be redeemed at any time, in whole or in part, at the option of the Company, at a redemption price equal to 110% of the liquidation preference on the redemption date plus an amount in cash equal to all accrued and unpaid dividends thereon to the redemption date. Upon the occurrence of a change of control, the Company will be required to make an offer to purchase the Series F Preferred Stock for cash at a purchase price of 101% of the liquidation preference thereof, together with all accumulated and unpaid dividends to the date of purchase.

The holders of Series F Preferred Stock have voting rights under certain circumstances.

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Upon the earlier of (i) the date that is sixty days after the date on which the Company closes an underwritten primary offering of at least \$200 million of its Common Stock, pursuant to an effective registration statement under the Securities Act or (ii) February 4, 2001, any outstanding Series F Preferred Stock will automatically convert into Series E Preferred Stock, on a one for one basis.

The Company may, at the sole option of the Board of Directors (out of funds legally available), exchange all, but not less than all, of the Series F Preferred Stock then outstanding, including any shares of Series F Preferred Stock issued as payment for dividends, for Exchange Debentures. The holders of Series F Preferred Stock are entitled to receive on the date of any such exchange, Exchange Debentures having an aggregate principal amount equal to (i) the total of the liquidation preference for each share of Series F Preferred Stock exchanged, plus (ii) an amount equal to all accrued but unpaid dividends payable on such share.

In September 2000, the Company repurchased and retired 2,965 shares of Series F Preferred Stock at 110% of its liquidation preference plus accrued and unpaid dividends for approximately \$3.3 million in accordance with the

provisions of the certificate of designation applicable to the Series F Preferred Stock.

On February 4, 2001, the Series F Preferred Stock converted into Series E Preferred Stock on a one for one basis (See Note 18 for a more detailed description).

#### SERIES A PREFERRED STOCK

There are 123,800 shares of Series A Cumulative Convertible Preferred Stock of KMC Holdings ("Series A Preferred Stock") authorized and outstanding. Such stock was issued to two entities, Nassau Capital Partners, L.P. and NAS Partners I L.L.C. ("Nassau Capital" and "Nassau Partners", respectively, collectively referred to as "Nassau") in January 1997 upon the conversion of certain notes payable and related accrued interest due to Nassau aggregating \$12,380,000. Series A Preferred Stock has a liquidation preference of \$100 per share and an annual dividend equal to 7.0% of the liquidation preference, payable quarterly, when and if declared by the Board of Directors out of funds legally available therefor. Unpaid dividends accumulate and the unpaid amount increases at the annual rate of 7.0%, compounded quarterly. All accumulated but unpaid dividends will be paid upon the occurrence of a Realization Event (defined as (i) an initial public offering with gross proceeds of at least \$40 million or (ii) sale of substantially all the assets or stock of the Company or the merger or consolidation of the Company into one or more other corporations). As of December 31, 2000, accumulated and unpaid dividends on the Series A Preferred Stock aggregated \$3,161,000. Notwithstanding the foregoing, pursuant to an agreement among Nassau and the Company, Nassau has agreed to forego the payment of dividends from September 22, 1997 through the date on which Nassau disposes of its interest in the Company; provided that at the time of such disposition, Nassau has received not less than a 10% annual compound rate of return during the period it held the Series A Preferred Stock.

Series A Preferred Stock is convertible into Common Stock at a conversion price equal to \$20.63 per share of Common Stock, subject to adjustment upon the occurrence of certain events. Holders of Series A Preferred Stock may convert all or part of such shares to Common Stock. Upon conversion, subject to the aforementioned agreement to forego the payment of dividends, the holders are entitled to receive a cash payment of the accumulated but unpaid dividends; provided, however, that the Company may substitute common shares having a fair market value equal to the amount of such cash payment if the conversion occurs before a Realization Event. Series A Preferred Stock will automatically convert into Common Stock upon the occurrence of a Qualified Public Offering (defined as the first sale of Common Stock pursuant to a registration statement filed under the Securities Act of 1933 in which the Company receives gross proceeds of at least \$40 million, provided that the per share price at which such shares are sold in such offering is at least four times the conversion price of the Series A Preferred Stock).

The holders of Series A Preferred Stock, except as otherwise provided in the Company's Certificate of Incorporation, are entitled to vote on all matters voted on by holders of Common Stock. Each share of Series A Preferred Stock is entitled to a number of votes equal to the number of shares of Common Stock into which such share is convertible. Without the prior consent of two-thirds of the shares of Series A Preferred Stock, among other things, the Company may not increase the number of shares of preferred stock (of whatever series) authorized for issuance, or declare or pay any dividends on shares of Common Stock or other junior shares. As discussed under "Redemption Rights" below, the holders of Series A Preferred Stock have certain redemption rights. Accordingly, such stock has been reflected as redeemable equity in the accompanying financial statements.

#### SERIES C PREFERRED STOCK

There are 350,000 shares of Series C Cumulative Convertible Preferred Stock of KMC Holdings ("Series C Preferred Stock") authorized, of which 175,000 shares are outstanding at December 31, 2000. One hundred fifty thousand of such

shares were issued in November 1997, generating aggregate gross proceeds of \$15 million and the remaining 25,000 shares were issued in January 1998 upon the conversion of an equal number of shares of Series D Preferred Stock. Series C Preferred Stock has a liquidation preference of \$100 per share and an annual dividend equal to 7.0% of the liquidation preference, payable quarterly, when and if declared by the Board of Directors out of funds legally available therefor. Unpaid dividends accumulate and the unpaid amount increases at the annual rate of 7.0%, compounded quarterly. All accumulated but unpaid dividends will be paid upon the occurrence of a Realization Event. As of December 31, 2000, accumulated but unpaid dividends on the Series C Preferred Stock aggregated \$4,286,000. Notwithstanding the foregoing, pursuant to the Purchase Agreement among the Company, Nassau, GECC and First Union Corp. ("First Union"), each current holder of Series C Preferred Stock has agreed to forego the payment of dividends that accumulate during the period from issuance through the date on which such holder disposes of its interest in the Company; provided that at the time of such disposition, it has received not less than a 10% annual compound rate of return during such period.

Series C Preferred Stock is convertible into Common Stock at a conversion price equal to \$42.18 per share of Common Stock; provided that such amount is subject to adjustment upon the occurrence of certain events. Holders of Series C Preferred Stock may convert all or part of such shares to Common Stock. Upon conversion, subject to the aforementioned agreement to forego the payment of dividends, the holders are entitled to receive a cash payment of the accumulated but unpaid dividends; provided, however, that the Company may substitute common shares having a fair market value equal to the amount of such cash payment if the conversion occurs before a Realization Event. Series C Preferred Stock will automatically convert into Common Stock upon the occurrence of a Qualified Public Offering.

The holders of Series C Preferred Stock, except as otherwise provided in the Company's Certificate of Incorporation, are entitled to vote on all matters voted on by holders of Common Stock. Each share of Series C Preferred Stock is entitled to a number of votes equal to the number of shares of Common Stock into which such share is convertible. Without the prior consent of two-thirds of the shares of Series C Preferred Stock, among other things, the Company may not increase the number of shares of preferred stock (of whatever series) authorized for issuance, or declare or pay any dividends on shares of Common Stock or other junior shares. As discussed under "Redemption Rights" below, the holders of Series C Preferred Stock have certain redemption rights. Accordingly, such stock has been reflected as redeemable equity in the accompanying financial statements.

The Series C Preferred Stock is subject to redemption at the option of the Company, in whole but not in part, in connection with an "Acquisition Event." An Acquisition Event is defined to mean any merger or consolidation of the Company with any other company, person or entity, whether or not the Company is the surviving entity, as a result of which the holders of the Company's Common Stock (determined on a fully diluted basis) will hold less than a majority of the outstanding shares of Common Stock or other equity interest of the Company, person or entity resulting from such transaction, or any parent of such entity.

#### SERIES D PREFERRED STOCK

There are 25,000 shares of Series D Cumulative Convertible Preferred Stock ("Series D Preferred Stock") authorized, none of which are outstanding at December 31, 1999 or 2000.

#### COMMON STOCK

Holders of Common Stock of the Company are entitled to one vote for each share held on all matters submitted to a vote of stockholders. Except as otherwise required by law, actions at the Company's stockholders meetings (held at least annually), require the affirmative vote of a majority of the shares represented at the meeting, a quorum being present. Holders of Common Stock are entitled, subject to the preferences of preferred stock, to receive such dividends, if any, as may be declared by the Board of Directors out of funds legally available therefor. The Senior Discount Note Indenture and the Company's other indebtedness restrict the ability of the Company to pay dividends on its Common Stock. Without the prior consent of two-thirds of the shares of Series A



Preferred Stock and two-thirds of the shares of Series C Preferred Stock, the

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Company may not declare or pay any dividends on its Common Stock. Except as discussed under "REDEMPTION RIGHTS" below, the holders of Common Stock have no preemptive, redemption or conversion rights.

Pursuant to provisions contained in an Amended and Restated Stockholders Agreement dated as of October 31, 1997, as further amended, among the Company, Kamine, Nassau, CIT Lending Services Corporation, GECC, First Union, Lucent and Dresdner Kleinwort Benson (the "Stockholders' Agreement"), these stockholders have agreed to vote their shares and take all necessary actions to elect the following individuals to the Company's board of directors: the Chief Executive Officer, the President, three individuals designated by Nassau, two individuals designated by Kamine, one individual designated by Dresdner and one individual as an independent director approved by Nassau, Kamine and other principal existing stockholders. Lucent or a person to whom Lucent transfers its shares may be entitled to designate one individual under certain circumstances. The number of directors each of Nassau, Kamine and Dresdner is entitled to designate will decrease as their respective percentages of ownership decrease. If a default relating to payment occurs under the Amended Senior Secured Credit Facility and continues uncured for 90 days, the holders of Series C Preferred Stock (currently Nassau, GECC and First Union) are entitled to elect two additional Directors, who will serve until the default is cured. In addition, under the certificate of designations relating to each of our Series E Preferred Stock and Series F Preferred Stock, if a default occurs under such certificate(s), the holders of Series E Preferred Stock and/or the holders of the Series F Preferred Stock will have the right to elect one additional individual each to serve as a director (for a total of two additional directors), in each case until the default is cured and all accrued dividends on such preferred stock are paid in full.

#### REDEMPTION RIGHTS

Pursuant to a stockholders agreement, certain of the Company's stockholders and warrant holders have "put rights" entitling them to have the Company repurchase their preferred and common shares and redeemable common stock warrants for the fair value of such securities if no Liquidity Event (defined as (i) an initial public offering with gross proceeds of at least \$40 million, (ii) the sale of substantially all of the stock or assets of the Company or (iii) the merger or consolidation of the Company with one or more other corporations) has taken place by the later of (x) October 22, 2003 or (y) 90 days after the final maturity date of the Senior Discount Notes. The restrictive covenants of the Senior Discount Notes limit the Company's ability to repurchase such securities. All of the securities subject to such "put rights" are presented as redeemable equity in the accompanying balance sheets.

The redeemable preferred stock, redeemable common stock and redeemable common stock warrants, which are subject to the stockholders agreement, are being accreted up to their fair market values from their respective issuance dates to their earliest potential redemption date (October 22, 2003). At December 31, 2000, the aggregate redemption value of the redeemable equity was approximately \$580 million, reflecting per share redemption amounts of \$1,454 for the Series A Preferred Stock, \$711 for the Series C Preferred Stock, \$338 for the Series G Preferred Stock and \$300 for the redeemable common stock and redeemable common stock warrants.

#### WARRANTS

In connection with a predecessor to the Amended Senior Secured Credit Facility, warrants to purchase 10,000 shares of Common Stock were issued to GECC in 1997. These warrants, at an exercise price of \$.01 per share, are exercisable from issuance through January 21, 2005. The fair value of such warrants was determined to be \$525,000, which was reflected as a charge to deferred financing costs and credited to redeemable equity. Pursuant to the Stockholders' Agreement, GECC may put the shares of Common Stock issuable upon the exercise of such warrants back to the Company. These warrants have been presented as redeemable common stock warrants in the accompanying balance sheet at December

31, 2000.

In connection with the sale of Senior Discount Notes in January 1998, the Company issued warrants to purchase an aggregate of 100,385 shares of Common Stock at an exercise price of \$.01 per share. The net proceeds of approximately \$10.4 million represented the fair value of the warrants at the date of issuance. In the first quarter of 2000 a portion of these warrants were exercised resulting in outstanding warrants to purchase an aggregate of 99,285 shares of Common Stock at December 31, 2000. The remaining warrants are exercisable through January 2008.

In connection with the February 4, 1999 issuances of the Series E Preferred Stock and the Series F Preferred Stock, warrants to purchase an aggregate of 24,660 shares of Common Stock were sold to Newcourt Finance (now CIT Lending Services) and Lucent. The aggregate gross proceeds from the sale of

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these warrants was approximately \$3.2 million. These warrants, at an exercise price of \$.01 per share, are exercisable from February 4, 2000 through February 1, 2009.

In addition, the Company also delivered to the Warrant Agent certificates representing warrants to purchase an aggregate of an additional 107,228 shares of Common Stock at an exercise price of \$.01 per share (the "Springing Warrants"). The terms of the Springing Warrants provide that they would become issuable under the circumstances described in the following paragraph.

If the Company fails to redeem all shares of Series F Preferred Stock prior to the date (the "Springing Warrant Date") which is the earlier of (i) the date that is sixty days after the date on which the Company closes an underwritten primary offering of at least \$200 million of its Common Stock pursuant to an effective registration statement under the Securities Act or (ii) February 4, 2001, the Warrant Agent is authorized to issue the Springing Warrants to the Eligible Holders (as defined in the warrant agreement) of the Series E and Series F Preferred Stock. The Company did not redeem all of the Series F Preferred Stock as of February 4, 2001 and therefore the "Springing Warrants" have become issuable. See Note 18 for further discussion regarding these springing warrants.

In connection with the April 30, 1999 issuance of additional shares of the Series E Preferred Stock, warrants to purchase an aggregate of 60,353 shares of Common Stock were issued to Newcourt Finance (now CIT Lending Services) and First Union. The aggregate gross proceeds from the sale of these warrants was approximately \$9.1 million. These warrants, at an exercise price of \$.01 per share, are exercisable from February 4, 2000 through February 1, 2009.

#### OPTIONS

Prior to the establishment of the present holding company structure, during 1996 and 1997, KMC Telecom granted options to purchase shares of its common stock, par value \$.01 per share ("KMC Telecom Common Stock"), to employees pursuant to the KMC Telecom Stock Option Plan.

In order to reflect the establishment of the holding company structure, on June 26, 1998, the Board of Directors adopted a new stock option plan, the KMC Holdings Stock Option Plan (the "1998 Plan"), which authorizes the grant of options to purchase Common Stock of the Company. The 1998 Plan was approved by the stockholders, effective July 15, 1998. In September 1998, the Company replaced the options to purchase KMC Telecom Common Stock previously granted under the KMC Telecom Stock Option Plan with options to purchase Common Stock of the Company granted under the 1998 Plan and granted options to additional employees of the Company under the 1998 Plan.

The 1998 Plan, which is administered by the Compensation Committee of the Board of Directors of KMC Holdings, provides for various grants to key employees, directors, affiliated members or other persons having a unique relationship with the Company excluding Kamine and any person employed by Nassau

Capital or any Nassau affiliate. Grants may include, without limitation, incentive stock options, non-qualified stock options, stock appreciation rights, dividend equivalent rights, restricted stocks, purchase stocks, performance shares and performance units. The Compensation Committee has the power and authority to designate recipients of the options and to determine the terms, conditions, and limitations of the options.

Under the 1998 Plan, options to purchase 600,000 shares of Common Stock of KMC Holdings are eligible for grant, of which 88,101 options have not been granted as of December 31, 2000. No individual may receive options for more than 75,000 shares. The exercise price of all incentive stock options granted under the 1998 Plan must be at least equal to the fair market value of the shares on the date of grant. The exercise price of all non-qualified stock options granted under the 1998 Plan must be at least 25% of the fair market value of the shares on the date of grant.

Options granted pursuant to the 1998 Plan will have terms not to exceed 10 years and become exercisable over a vesting period as specified in such options. The 1998 Plan will terminate no later than 2008. Options granted under the 1998 Plan are nontransferable, other than by will or by the laws of descent and distribution, and may be exercised during the optionee's lifetime, only by the optionee.

The 1998 Plan provides for an adjustment of the number of shares exercisable in the event of a merger, consolidation, recapitalization, change of control, stock split, stock dividend, combination of shares or other similar

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changes, exchange or reclassification of the Common Stock at the discretion of the Compensation Committee. Pursuant to the agreements adopted under the 1998 Plan, the greater of 25% of the shares granted or fifty percent of all unvested options granted become fully vested upon a change-in-control of the Company, as defined. Under certain circumstances, such percentages may increase.

The holders of options to acquire shares of Common Stock of KMC Holdings are required to enter into agreements with KMC Holdings which place certain restrictions upon their ability to sell or otherwise transfer such shares. In the event of termination of employment of the option holder by the Company or the affiliates, the Company can repurchase all of the shares or options held by such individuals, generally for an amount equal to the fair value of such shares or the excess of the fair value of such options over their exercise price.

Information on stock options is as follows:

	NUMBER OF SHARES		WEIGHTED AVERAGE EXERCISE PRICE OF OPTIONS
	OUTSTANDING	EXERCISABLE	
Balances, January 1, 1998.....	141,500	19,000	\$ 65
Granted.....	262,500	-	\$ 26
Became exercisable.....	-	117,000	
Cancelled.....	(141,500)	(19,000)	\$ (65)
Balances, December 31, 1998.....	262,500	117,000	\$ 26
Granted.....	82,342	-	\$ 147
Became exercisable.....	-	51,669	
Exercised.....	(15,600)	(15,600)	\$ 22
Cancelled.....	(27,200)	(2,000)	\$ (26)
Balances, December 31, 1999.....	302,042	151,069	\$ 59
Granted.....	255,674	-	\$ 173
Became exercisable.....	-	136,929	
Exercised.....	(7,803)	(7,803)	\$ 77
Cancelled.....	(38,014)	(4,726)	\$ (158)
Balances, December 31, 2000.....	511,899	275,469	\$ 109

The weighted-average exercise price of options exercisable at December 31, 1998, 1999 and 2000 is \$22, \$26 and \$48, respectively, and the weighted-average fair value of options granted during 1998, 1999 and 2000 were \$114, \$134 and \$236 per share, respectively.

The range of exercise prices, number of shares and the weighted-average remaining contractual life for options outstanding as of December 31, 2000 were as follows:

RANGE OF EXERCISE PRICES	NUMBER OF SHARES	NUMBER OF SHARES EXERCISABLE	WEIGHTED- AVERAGE EXERCISE PRICE	WEIGHTED- AVERAGE REMAINING CONTRACTUAL LIFE
\$20-\$50	215,950	193,999	\$ 26	7.5 years
\$51-\$100	120,000	55,937	\$ 75	9.2 years
\$101-\$150	45,407	18,590	\$ 125	7.5 years
\$200-\$250	72,876	6,343	\$ 248	9.0 years
\$251-\$300	57,666	600	\$ 300	9.6 years
	-----	-----		
Total \$20 - \$300	511,899	275,469	\$109	7.5 years
	=====	=====		

During the year ended December 31, 2000, non-qualified options to purchase an aggregate of 255,674 shares were granted to employees, directors and independent contractors who perform services for the company, at exercise prices of \$75 (127,500), \$125 (2,500), \$250 (64,508) and \$300 (61,166). All such

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options have 10 year terms. The options issued at \$75 are 25% vested upon issuance and vest 12.5% every six months thereafter. The options issued at \$125 have immediate vesting. Of the options issued at \$250, 23,500 options vest annually over three years, 40,008 options vest 10% every six months and 1,000 options fully vest after one year. The options issued at \$300 vest 10% every six months.

During the year ended December 31, 1999, non-qualified options to purchase an aggregate of 82,342 shares were granted to employees at exercise prices of \$125 (67,509), \$225 (2,933) and \$250 (11,900). All options have 10 year terms and become exercisable over a five year period in equal six month increments

As a result of restrictions upon the holders of options granted under the 1998 Plan, including their ability to sell or otherwise transfer the related shares, the 1998 Plan is required to be accounted for as a variable stock option plan. Generally accepted accounting principles for variable stock option plans require the recognition of a non-cash compensation charge for these options (amortized over the vesting period of the employee options and recognized in full as of the grant date for the non-employee options). Such charge is determined by the difference between the fair value of the common stock underlying the options and the option price as of the end of each period. Accordingly, compensation expense will be charged or credited periodically through the date of exercise or cancellation of such stock options, based on changes in the value of the Company's stock as well as the vesting schedule of such options. These compensation charges or credits are non-cash in nature, but could have a material effect on the Company's future reported results of

operations.

The Company, upon cancellation of the outstanding options under the KMC Telecom Stock Option Plan, reversed all compensation expense previously recorded with respect to such options. Additionally, to the extent the fair value of the Common Stock of the Company exceeded the exercise price of the options granted under the 1998 Plan, the Company recognized compensation expense related to such options over their vesting period.

Based on the estimated fair value of the Common Stock KMC Holdings at December 31, 1998, December 31, 1999 and December 31, 2000, cumulative deferred compensation obligations of \$27,906,000, \$50,972,000, and \$89,190,000 respectively, have been established. The Company has recognized compensation expense aggregating \$7,080,000, \$29,833,000 and \$34,571,000 for the years ended December 31, 1998, 1999 and 2000, respectively. The 1998 stock option compensation expense of \$7,080,000 reflects charges of \$7,236,000 under the KMC Telecom Stock Option Plan through its termination in September 1998 and charges of \$21,190,000 related to the 1998 Plan, partially offset by a credit as a result of the September 1998 cancellation of the KMC Telecom stock options, reflecting the reversal of \$21,346,000 of cumulative compensation previously recognized for options granted under the KMC Telecom Stock Option Plan.

In accordance with the provisions of Statement 123, the Company applies APB 25 and related interpretations in accounting for its stock option plan. If the Company had elected to recognize compensation expense based on the fair value of the options granted at the grant date as prescribed by Statement 123, net loss and net loss per common share would have been the following:

	1998	DECEMBER 31, 1999	2000
	-----		
	(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)		
Net loss:			
As reported.....	\$ (76,753)	\$ (225,716)	\$ (359,687)
	=====	=====	=====
Pro forma.....	\$ (76,869)	\$ (219,599)	\$ (369,114)
	=====	=====	=====
Net loss per common share:			
As reported.....	\$ (114.42)	\$ (360.88)	\$ (531.21)
	=====	=====	=====
Pro forma.....	\$ (114.56)	\$ (353.70)	\$ (542.24)
	=====	=====	=====

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The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	1998	1999
	-----	
2000		
	-----	
Expected dividend yield.....	0%	0%
0%		

Expected stock price volatility.....	50%	70%
85%		
Risk-free interest rate.....	6.0%	6.5%
6.0%		
Expected life of options.....	7 years	7 years
7 years		

The expected stock price volatility factors were determined based on an average of such factors as disclosed in the financial statements of peer companies. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

#### 8. INFORMATION BY BUSINESS SEGMENT

The Company has two reportable segments as defined by FASB Statement No. 131, "DISCLOSURES ABOUT SEGMENTS OF AN ENTERPRISE AND RELATED INFORMATION": a Tier III Markets segment and a Nationwide Data Platform segment. The Company owns and operates robust fiber-based networks and switching equipment in all of its 37 Tier III markets, which are predominantly located in the South, Southeast, Midwest and Mid-Atlantic United States. The Nationwide Data Platform segment provides local Internet access infrastructure and other enhanced data services in over 140 markets nationwide.

The Company evaluates the performance of its operating segments based on earnings before interest, taxes, depreciation and amortization, excluding general corporate expenses and stock compensation expense ("Adjusted EBITDA"). There are no significant intersegment transactions.

Prior to the development of the Nationwide Data Platform segment in late fiscal 2000, the Company was managed as one reporting segment for the fiscal years ended 1998 and 1999. Therefore, segment data for such years is not presented.

#### YEAR ENDED DECEMBER 31, 2000 (IN THOUSANDS)

	TIER III MARKETS	NATIONWIDE DATA PLATFORM	CORPORATE	TOTAL
	-----	-----	-----	-----
Revenues.....	\$ 161,938	\$ 47,257	\$ -	\$ 209,195
Adjusted EBITDA.....	(124,545)	1,667	205	(122,673)
Depreciation and amortization....	(62,842)	(1,409)	(11,878)	(76,129)
Stock compensation expense.....	(1,037)	(346)	(33,188)	(34,571)
Interest income.....	8,429	1,188	2,167	11,784
Interest expense.....	(122,290)	(227)	(13,876)	(136,393)
Cumulative effect of change in accounting principle.....	(1,705)	-	-	(1,705)
Net income (loss).....	(303,990)	873	(56,570)	(359,687)
Dividends and accretion on redeemable preferred stock	-	-	(94,440)	(94,440)

Net income (loss) applicable to shareholders.....	\$ (303,990)	\$ 873	\$ (151,010)	\$ (454,127)
Total assets.....	\$ 971,861	\$ 263,708	\$ 95,706	\$1,331,275
Capital expenditures.....	\$ 274,191	\$ 176,970	\$ 6,490	\$ 457,651

## SERVICE REVENUES

The Company provides on-net switched and dedicated services and resells switched services previously purchased from the incumbent local exchange carrier. On-net services include both services provided through direct connections to our own networks and services provided by means of unbundled network elements leased from the incumbent local exchange carrier.

The Company's service revenues consist of the following:

	YEAR ENDED DECEMBER 31,		
	1998	1999	2000
	(IN THOUSANDS)		
On-net.....	\$ 8,248	\$44,615	\$198,177
Resale.....	14,177	19,698	11,018
Total.....	\$22,425	\$64,313	\$209,195

## 9. SIGNIFICANT CONTRACTS AND CUSTOMERS

In March 2000, the Company entered into an agreement with Qwest Communications Corporation and Qwest Communications International, Inc. (collectively, "Qwest") pursuant to which (i) the Company purchased approximately \$134 million of Internet infrastructure equipment (the "KMC Funding V Equipment") from Qwest and (ii) the Company agreed to install and maintain this equipment, throughout the United States, principally to handle Internet service provider traffic on behalf of Qwest. As amended, the services agreement is for a term of 51 months, commenced in August 2000 and expires in October 2004.

In June 2000, the Company entered into a second agreement with Qwest, pursuant to which (i) the Company purchased approximately \$168 million of Internet infrastructure equipment from Qwest and (ii) the Company agreed to install and maintain this equipment, in cities throughout the United States, principally to handle Internet service provider traffic on behalf of Qwest. The second services agreement commenced in November 2000 and expires in July 2005.

## 10. INCOME TAXES

As of December 31, 2000, the Company and its subsidiaries had consolidated net operating loss carryforwards for United States income tax purposes ("NOLs") of approximately \$500 million which expire through 2020. Under Section 382 of the Internal Revenue Code of 1986, as amended, if the Company undergoes an "ownership change," its ability to use its preownership change NOLs

(NOLs accrued through the date of the ownership change) would generally be limited annually to an amount equal to the product of (i) the long-term tax-exempt rate for ownership changes prescribed monthly by the Treasury Department and (ii) the value of the Company's equity immediately before the ownership change, excluding certain capital contributions. Any allowable portion of the preownership change NOLs that is not used in a particular taxable year following the ownership change could be carried forward to subsequent taxable years until the NOLs expire, usually 20 years after they are generated. As a result of the cumulative effect of issuances of preferred and common stock through September 22, 1997, KMC Telecom has undergone an ownership change.

For financial reporting purposes, the Company has an aggregate of approximately \$311 million and \$671 million of loss carryforwards and net temporary differences at December 31, 1999 and 2000, respectively. At existing federal and state tax rates, the future benefit of these items approximates \$121 million at December 31, 1999 and \$262 million at December 31, 2000. Valuation allowances have been established equal to the entire net tax benefit associated with all carryforwards and temporary differences at both December 31, 1999 and 2000 as their realization is uncertain.

The composition of expected future tax benefits at December 31, 1999 and 2000 is as follows:

	1999	2000
	(IN THOUSANDS)	
Net operating loss carryforwards.....	\$ 83,762	\$ 195,177
Temporary differences:		
Stock option compensation.....	19,528	33,011
Interest accretion.....	21,127	34,025
Other, net.....	(3,244)	(419)
Total deferred tax assets.....	121,173	261,794
Less valuation allowance.....	(121,173)	(261,794)
Net deferred tax assets.....	\$ -	\$ -

A reconciliation of the expected tax benefit at the statutory federal rate of 35% is as follows:

	1998	1999
2000		
Expected tax benefit at statutory rate.....	(35.0)%	(35.0)%
(35.0)%		
State income taxes, net of federal benefit.....	(2.6)	(3.8)
(4.2)		
Non-deductible interest expense.....	2.0	1.1
0.8		
Other.....	0.1	0.1
0.1		
Change in valuation allowance.....	35.5	37.6
38.3		



$-\frac{9}{8}$ 
 $-\frac{9}{8}$

## 11. COMMITMENTS AND CONTINGENCIES

## LEASES

The Company leases various facilities and equipment under operating leases. Minimum rental commitments are as follows (IN THOUSANDS):

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YEAR ENDING DECEMBER 31:

2001.....	\$ 9,737
2002.....	8,403
2003.....	7,602
2004.....	7,039
2005.....	5,224
Thereafter.....	22,485
	-----
	\$60,490
	=====

Rent expense under operating leases was \$1,299,000, \$3,815,000, and \$7,835,000 for the years ended December 31, 1998, 1999 and 2000, respectively. The amounts presented above for the year ending December 31, 2001 exclude minimum rental commitments of \$40.4 million associated with the Company's operating lease for the KMC Funding V Equipment which was terminated in March 2001 as more fully described in Note 18.

## LITIGATION

There are a number of lawsuits and regulatory proceedings related to the Telecommunications Act of 1996, decisions of the Federal Communications Commission related thereto and rules and regulations issued thereunder which may affect the rights, obligations and business of incumbent local exchange carriers, competitive local exchange carriers and other participants in the telecommunications industry in general, including the Company.

## PURCHASE COMMITMENTS

As of December 31, 2000, the Company has outstanding commitments aggregating approximately \$17 million related to purchases of telecommunications equipment and fiber optic cable and its obligations under its agreements with certain suppliers and service providers.

## EMPLOYMENT AGREEMENTS

The Company has entered into employment agreements with certain of its executives. In addition to a base salary, these agreements also provide for certain incentive compensation payments, based upon the attainment of certain business and financial milestones.

## ARBITRATION AWARD

During the second quarter of 1999, the Company recorded a \$4.3 million charge to other expense in connection with an unfavorable arbitration award. The net amount due under the terms of the award was paid in full in June 1999.

## 12. RELATED PARTY TRANSACTIONS